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# IRS Announcement Regarding Effect of Entity Payment of Tax on SALT Deduction Limitation

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Practice Area: Tax

The 2017 federal tax reform legislation included a limitation on the individual itemized deduction for state and local taxes ("SALT"). The limit is $10,000 per joint return and $5,000 per return for married taxpayers that file separately.

Some high individual tax states attempted to help their taxpayers blunt the effect of this new limitation by allowing them to make charitable contributions to the state in exchange for a corresponding credit against their individual state taxes. The expectation was that individuals doing so would be able to deduct the full charitable contribution on their federal income tax returns, and thereby reduce the effect of the SALT deduction limitation.

The IRS and Treasury responded, however, by issuing regulations limiting the deduction for such charitable contributions. The IRS viewed the changes made by those states as inappropriate attempts to "circumvent" the 2017 SALT deduction limitation.

Wisconsin also subsequently passed legislation motivated in large part by the federal SALT limitation. It does not apply to all taxpayers. Instead, it provides a potential means for owners of Wisconsin entities taxed as S corporations ("tax-option corporations" in Wisconsin terminology) or as partnerships (which would include most multi-member LLCs) to reduce the adverse effect of the federal SALT deduction limitation.

By way of background, its long been the case that the income of such Wisconsin entities is, as a general rule, "passed through" to the owners, who include it on their individual income tax returns–the owners pay tax on the income, and the entity does not. Such income tax paid by individual owners is subject to the federal SALT deduction limitation.

Beginning in 2018 for "tax-option corporations" and 2019 for entities taxed as partnerships, Wisconsin permits the entity to elect to pay tax on the entity's income at the entity level, rather than passing it through to the owners. Entities making the election must pay Wisconsin tax on the income at a 7.9% rate, which is the current Wisconsin corporate income tax rate and higher than Wisconsin's top marginal individual income tax rate at 7.65%.

The election by the Wisconsin entity would reduce the net income passed through to its owners and, in turn, reduce the amount of Wisconsin income tax the owners pay directly. The hope was that the making of the election would effectively provide a full federal tax benefit to the owners for the Wisconsin taxes paid on the income by the entity.

Since Wisconsin's entity level election went into effect, there has been some concern that the IRS may treat the Wisconsin entity level election as a device similar to the charitable contribution/state tax credit strategy referred to above, and adopt rules to eliminate the resulting federal income tax benefit. Fortunately, that appears not to be the case.

On Monday, November 9, 2020, the IRS issued Notice 2020-75, which commences the rule making process under which the Treasury Department plans to issue regulations regarding provisions such as the Wisconsin election. The Notice indicates that such elections will be respected for federal income tax purposes (i.e., that the IRS will not seek to eliminate the benefit owners will receive from the payment of Wisconsin tax at the entity, rather that the individual, level on tax option corporation and tax partnership income), though, because no particular state law or election is discussed in the Notice, we cannot predict whether the IRS will draw distinctions among potential approaches or conclude any aspect of the Wisconsin election takes it outside the protection of the expected regulations.

The expected regulations would allow a deduction to the passthrough entity for tax payments made by it to a state or municipality to satisfy income tax liabilities, including elective tax payments made by the passthrough entity even if those have the effect of giving the owners a full or partial deduction, exclusion, or credit for their portion of the state tax liability. The Notice explains that the tax payments by the entity will reduce each owner's share of non-separately stated income for federal income tax purposes on the Schedule K-1 issued to the owner. The resulting practical effect is a full federal "deduction" for the state taxes of the passthrough entity.

We expect this new guidance from the IRS may increase the number of Wisconsin passthrough entities that make an election to pay tax on income at the entity level. Making the election could be particularly beneficial for owners who have relatively sizeable Wisconsin income from sources other than the income passed through from the entity, and already have Wisconsin SALT payments relating to, for example, real estate taxes on a home, salary income or other sources.

Tax projections at the entity and owner levels are required to determine if the Wisconsin election will be beneficial. The Wisconsin marginal tax rates of the owners other than on the income that would be passed through from the entity to them will need to be examined. The existence of Wisconsin net operating losses, Wisconsin capital gains and other factors will also affect the decision.

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